

DOCKET SECTION

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268

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WASHINGTON, D.C. 20268

Postal Rate and Fee Changes, 1997

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Docket No. R97-1

RIAA, ET AL. BRIEF

The Recording Industry Association of America and Advertising Mail Marketing Association ("RIAA, et al.") submit this brief in accordance with the briefing schedule established by the Commission.

The United States Postal Service ("USPS" or the "Postal Service") have requested the imposition of a surcharge on Standard Mail (A) mailpieces that are "prepared as a parcel or [are] not letter or flat shaped." Proposed DMCS § 321.25. Request of the United States Postal Service for a Recommended Decision on Changes in Rates of Postage and Fees for Postal Services, Docket No. R97-1, Attachment A, page 25 ("USPS Request"). The appropriate level of this surcharge is subject to more than some doubt. It ranges from 3.2 cents to 8.9 cents at the maximum.

The Postal Service has effectively conceded that there was an elemental mistake in the cost analysis of Mr. Crum underlying the surcharge. Mr. Crum failed to consider the net revenue effects to the Postal Service resulting from the fact that parcels yield, on average, greater revenues than flats. Both Gary M. Andrew, testifying for RIAA, et al. and Michael R. McGrane, testifying for the Postal Service, conclude that the per piece average difference in revenue between parcels and flats during fiscal year

1996 was 24.6 cents. See Tr. 22/11654 (Table 1) (Andrew); Tr. 35/18962 (Table 1) (McGrane).

Before turning to the proper application of this agreed revenue differential, we must pause briefly with Mr. Crum's cost-side analysis. Dr. Andrew demonstrates that Mr. Crum made two other important mistakes in his analysis of the cost differential between parcels and flats.

Roughly seventeen percent of the attributable costs associated by Mr. Crum's analysis with parcels were made up of transportation-related costs employing a distribution key based on the "cube of mail."^{1/} Although distributing transportation related costs based on the number of cubic feet of each of the shapes under examination is unobjectionable, this is not a measured number, but one that must be estimated:

In the USPS' study of the costs of Standard (A) mail by shape, transportation costs incurred by highway and railroad movements and vehicle service drivers are distributed to letters, flats and parcels based on the distribution of cubic feet ("cube") of mail in each respective shape. However, unlike weight, the cubic feet of the mail flows is not measured by any of the ongoing data collection systems of the USPS. In the study used by Witness Crum to support the ten cent per piece parcel surcharge, the cubic feet of each shape is estimated by dividing the total weight of the shape by the average density of the shape.

Tr. 22/11665 ll. 2-8 (Andrew) (footnote omitted). The average density of the various

^{1/} See, e.g., USPS-T-28 Exhibit K, Table 3, rows 8A and 8 Total, 14.1B and C and Distribution Key 4 ((17337+49691+17471)/507459)=16.65%.

shapes of mail was estimated (in turn) by reference to special studies conducted by the Postal Service:

In this proceeding, the average density of letters and the average density of flats were based on a specific study performed as part of PRC Docket No. MC95-1, while the average density of parcels was based on a study conducted for PRC Docket MC97-2 utilizing a completely different methodology.

Id. II. 8-11 (footnote omitted).

As Dr. Andrew testified, there are a variety of reasons to be suspicious of the parcel density number used by Mr. Crum. Tr. 22/11665-75. Dr. Andrew advocated using the parcel density estimated by the Postal Service through the Docket No. MC95-1 study. He then performed a redistribution of transportation related costs based on the use of that substantially higher estimation of density and concluded that Mr. Crum's analysis had overstated the cost difference between parcels and flats by 3.28 cents in consequence of the use of the less reliable of two the Postal Service supported studies of parcel density. Tr. 22/11675.

The Postal Service has presented no testimony rebutting this aspect of Dr. Andrew's analysis of the parcel/flat cost difference and it should be accepted as accurate. See Tr. 35/18981, II. 5-15 (McGrane).

The second flaw that Dr. Andrew found in Mr. Crum's parcel/flat cost differential analysis relates to the distribution of the mail processing costs that make up almost half

of the total attributable costs analyzed by Mr. Crum.^{2/} The thrust of Dr. Andrew's criticism is this:

However, the single MODS office system average variability was used for every Non-MODS office cost pool. This causes loss of individual and proper weighting of the distribution key by cost pool variability. The resulting distributed costs are by shape (letter, flats and parcels) of the Non-MODS offices in LR-H-106 and the contribution to the alleged difference between the costs of parcels and flats are therefore meaningless.

Tr. 22/11662 ll. 1-5. The phenomenon is illustrated in a table appended to Dr. Andrew's response to USPS/RIAA, et al.-T1-33 (Tr. 22/11712) which is reproduced on the following page.

^{2/} See, e.g., USPS-T-28, Exhibit K at Table 3 (line 3.1, $3422,631/\text{total attributable } 7,092,588=.48$).

Illustrative Example of Distortion Caused by the Use of MODS System Average Variability in Non-MODS Cost Pools

MODS Costs with Pool Level Variabilities

Cost Pools (1)	Accrued Costs (2)	Volume Variability		Distribution of Volume Variable Costs			
		(percent) (3)	(dollars) (4)	Keys (percent)		Costs (dollars)	
				Shape A (5)	Shape B (6)	Shape A (7)	Shape B (8)
1. Manual	\$ 1,000	30%	\$ 300	30%	70%	\$ 90.0	\$ 210.0
2. Machine	\$ 500	90%	\$ 450	65%	35%	\$ 292.5	\$ 157.5
3. MODS Total	\$ 1,500		\$ 750			\$ 382.5	\$ 367.5
4. MODS System Average		50%					
5.	Cost Difference (Shape B - Shape A)						\$ (15.00)

Non-MODS Costs with MODS System Average Variabilities

Cost Pools (1)	Accrued Costs (2)	Volume Variability		Distribution of Volume Variable Costs			
		(percent) (3)	(dollars) (4)	Keys (percent)		Costs (dollars)	
				Shape A (5)	Shape B (6)	Shape A (7)	Shape B (8)
6. Manual	\$ 1,000	50%	\$ 500	30%	70%	\$ 150.0	\$ 350.0
7. Machine	\$ 500	50%	\$ 250	65%	35%	\$ 162.5	\$ 87.5
8. Non-MODS Total	\$ 1,500		\$ 750			\$ 312.5	\$ 437.5
9. Non-MODS System Average		50%					
10.	Cost Difference (Shape B - Shape A)						\$ 125.00

[For ease of illustration 1) All characteristics of the MODS and the Non-MODS Cost Pools were held constant except the Volume Variability at the Cost Pool level and
2) Only one unit of each shape is considered.]

As Dr. Andrew put it:

This demonstrates the critical point that was overlooked in the implementation in LR-H-146 where witness Bradley's MODS system average variability was applied to each non-MODS cost pool. The impact of the interaction between individual cost pool variabilities and distribution key can distort the differences between shapes. Therefore, the non-MODS component of volume variable costs should not be permitted to contribute to the difference in costs between parcels and flats.

Tr. 22/11711. Precisely because neither Dr. Andrew nor the Postal Service has good information concerning the distribution of non-MODS office mail processing costs by shape, Dr. Andrew proposed to avoid the sort of distortion proved possible to result from the Bradley/Smith methodology by a straightforward procedure:

For each subclass, the Non-MODS office costs were aggregated and redistributed to shape proportional to the number of pieces. The volume variable costs for MODS offices, BMC's, and remote encoding costs have been accepted as developed by Witness Smith and utilized by Witness Crum.

This procedure allows the total volume variable costs to remain unchanged but prevents the variable costs of the Non-MODS office from contributing to the difference between costs of parcels and the costs of flats.

Tr. 22/11662 (footnote omitted). The result was to reduce the difference in mail processing costs between parcels and flats by 2.33 cents. Tr. 22/11664.

U.S. Postal Service Witness Carl G. Degen purports in Part XXIII of his rebuttal testimony (Tr. 36/19362-64) to demonstrate that Dr. Andrew was wrong. He concedes that Dr. Andrew is theoretically correct (Tr. 36/19363) and concedes that he (Mr. Degen) is "not familiar with what he [Dr. Andrew] did with respect to redistribution by shape at all." Mr. Degen goes on to explain that "to the extent [Dr. Andrew's] theory

regarding shape relies on the fact that that subclass distribution is different, that is the point that I have addressed."

We submit that Mr. Degen misread Dr. Andrew's presentation. It is not a redistribution of non-MODS mail processing costs by subclass that was at the heart of Dr. Andrew's demonstration, but the fallacious distribution to shape based upon average MODS office shape distributions to which Dr. Andrew objected. Precisely because Dr. Andrew redistributing the non-MODS office mail processing costs to shape and Mr. Degen was focused on redistributing those costs to the subclasses, the two pieces of analysis have nothing (or next to nothing) to do one with the other and Mr. Degen cannot be thought to have rebutted Dr. Andrew's presentation successfully. Mr. Degen himself admitted as much:

I am not addressing his specific alternative shape redistribution in my testimony and, to the extent it is independent of the fact that I have shown that the subclass redistribution doesn't change, then it would stand on its own. To the extent it relies on that fact, then I guess I am disagreeing with it.

Tr. 36/19372.

Taking these two corrections into account, Mr. Crum overstated costs by 5.6 cents.

And now to the integration of costs and revenues. While at least tacitly conceding that Dr. Andrew was right to offset the cost differences between parcels and flats with the revenue differences, the Postal Service had one quibble with his methodology in doing so. "He [Dr. Andrew] compares *unadjusted* costs to *adjusted* revenues, an 'apple to orange' comparison." Tr. 35/18958 ll. 5-6. Dr. Andrew

exhaustively explained in the course of both written (Tr. 22/11706-08) and oral (Tr. 36/11720-24) cross-examination why he made the comparison that he did. Although Mr. Crum was plainly right in adjusting his cost differential analysis to reflect the extent to which flats are more deeply dropshipped and finely sorted than parcels, it is not possible to make a similar adjustment to the revenues produced by the two shapes of mail. As Dr. Andrew testified:

A. On the revenue side, it is not clear that the direction or magnitude of the drop shipping and the fineness of presortation has -- you have no idea what the impact is.

Q. You don't know what it is?

A. Well, from the data that was available, it is impossible to determine that impact.

Tr. 22/11720 ll. 5-10.

Mr. McGrane's methodology for adjusting revenue due to dropshipment illustrates this point. What he does is to adjust downward the revenue differential between parcels and flats owing to dropshipping. The McGrane methodology for adjustment multiplies the number of pounds of parcels and flats at each dropship discount entry point by the per pound discount rates in order to come to a total number of discount dollars, adds all of these sums for each of flats and parcels and divides by the total number of flats and parcels to get an average dropship discount per piece.

Tr. 36/18966, 18969 (Commercial mail).

This neglects the important fact that pieces below the break point receive a discount equal to that accorded to a piece at the break point. The number of such pieces is unknown. This is one of the reasons that Dr. Andrew was right in declining to make a revenue-side adjustment, and one of the reasons that the adjustment

advocated by Mr. McGrane is unreliable. The same phenomenon infests Mr. McGrane's presortation discount analysis.

Thus, we submit that Dr. Andrew had it exactly right when, after reducing Mr. Crum's cost figure by 5.6 cents and offsetting the agreed 24.6 cents of revenue difference, he concluded that "the maximum surcharge for parcels that can be justified using Witness Crum's methodology and available data is 3.2 cents per piece" Tr. 22/11651 ll. 17-18.

Mr. McGrane advocates reducing an unadjusted version of Mr. Crum's costs (which we know to be wrong and know how to correct) by the unadjusted revenue difference to get the net revenue effect of parcel/flat differentials. The number that would result, when one corrects Mr. Crum's costs by the Dr. Andrew 5.6 cent adjustment, is a cost differential of 34.7 cents (40.3 cents, Tr. 36/18958, less 5.6 cents). When reduced by the 24.6 cents agreed revenue differential, this produces a net differential of 10.1 cents. The proposed surcharge would recapture all of this.

Alternatively, Mr. McGrane suggests that one could compare adjusted revenues (which we know are likely to be wrong, but have no good method to correct) with adjusted costs. If one does this comparison, again taking into account the 5.6 cent cost correction and employing the rates that were in effect for three quarters of FY 1996, Tr. 36/18994 ll. 3-17, an 8.1 cent differential results. This calculation is displayed at RIAA/USPS-XE-1, Tr. 36/18996.

Finally, Dr. Andrew testified that a surcharge that could be applied in a way that was revenue neutral with maintenance of the base rates proposed by the Postal Service for Standard (A) commercial mail (both regular and ECR) is 8.9 cents per piece.

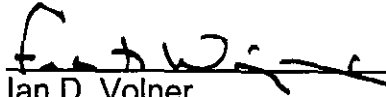
Thus, there is more than some doubt as to the proper surcharge level. It ranges from the 3.2 cents calculated by Dr. Andrew to the 10.1 cents derived from Mr. McGrane's unadjusted cost/price numbers with stops at 8.1 cents (the corrected McGrane adjusted cost/price comparison) and 8.9 cents (the largest reduction from the 10 cent proposal that can be taken while retaining revenue neutrality with the USPS proposed base rates).

One further consideration that should guide the Commission in its adjudication of an appropriate shape-based surcharge is the uncertainty of some of the analysis involved here. Mr. Crum testified that there was almost certainly some error in the categorization of parcels and rates in the special study on which most of his costing analysis rested. Tr. 5/2384 ll. 1-7. The informal survey of RIAA, et al. members conducted by Gary Andrew suggests that even the MC95-1 density numbers advocated by Dr. Andrew may well be too low. Tr. 22/11671 l. 7-73 l. 2.

All told, the one thing that seems clear from all of this is that a substantially more rigorous study of the real net cost/price differential between parcels and flats is imperative. We urge that the Commission use caution in determining the appropriate level of an interim surcharge pending the conclusion of such further study, and to set

the surcharge at the lowest permissible level consistent with the maintenance of revenue neutrality.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Ian D. Volner", is written over a horizontal line.

Ian D. Volner

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CERTIFICATE OF SERVICE

I hereby certify that I have on this date served this document upon all participants of record in this proceeding in accordance with section 12 of the rules of practice.


N. Frank Wiggins

DATE: April 1, 1998